5.04 Foreign Currency Exchange Transaction Hedging: Cash Flow Hedge

As the name implies, a cash flow hedge protects an entity from fluctuations in cash flows. If an entity enters into a contract involving a receivable or payable that will be settled in a foreign currency at some point in the future (ie, a **forecasted transaction** or **anticipated transaction**), the entity may enter into a forward exchange contract to make certain that the number of dollars required to settle the contract do not fluctuate as the exchange rate changes.

When a derivative such as a forward exchange contract is accounted for as a cash flow hedge, it too, like all derivatives, must be adjusted to its fair value on each balance sheet date. The change in value, however, is not reported in profit or loss but, rather, it is reported in **other comprehensive income (OCI)**. The amount in OCI is reversed when the effect is recognized on the hedged transaction.

For example, in performing its analysis of capital budgeting for the next few years, a company decides it will be purchasing an expensive piece of equipment from a European supplier in 6 months. The cost is €200,000 and the 6-month forward exchange rate is 1.30. As a result, the company budgets $260,000 for the purchase.

To avoid changes in the dollar amount of the purchase price due to changes in the exchange rate, the company enters into a forward exchange contract to purchase 200,000 Euros at the 6-month forward exchange rate of 1.30.

After 2 months, when the company is preparing its year-end financial statements, the 4-month forward exchange rate is 1.35. As a result of an increase in the exchange rate of .05, the fair value of the forward exchange contract will be approximately $10,000.

Since the company has not contracted to purchase the equipment, it has nothing to report on its balance sheet in relation to it. The gain on the forward exchange contract would be reported in OCI and reclassified when the hedged transaction is affected.

The entry on the balance sheet date would be:

Forward exchange contract	10,000	
Unrealized **gain** due to increase in value of forward exchange contract **(OCI)**		10,000

Assume the exchange rate remains at 1.35 when the company purchases the equipment.

The combined entry would be:

Equipment	260,000	
Unrealized **gain** due to increase in value of forward exchange contract (OCI)	10,000	
Cash (received from counterparty)	10,000	
Forward exchange contract		10,000
Cash (paid to equipment vendor)		270,000